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THE EU'S ROLE IN SUPPORTING CRISIS-HIT COUNTRIES IN CENTRAL AND EASTERN EUROPE

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Highlights

- The crisis hit central and eastern Europe (CEE) hard. GDP forecasts for 2010 for 30 countries in the region were adjusted downwards by an average of 15.8 percent between October 2007 and October 2009. This marks a major reversal because, before the crisis, CEE countries seemed to be benefiting strongly from membership of, or closer ties with, the European Union.
- The EU and its institutions have mobilised substantial funds to support crisis-hit CEE countries. Coordinated multilateral financial assistance has had stabilising effects, and the banking system has played a crucial role. Western European banks have remained committed to the region.
- However, certain actions, or failures to act, on the part of EU institutions and governments, have amplified the effects of the crisis on CEE countries. The European Central Bank has given little direct support to non-euro-area countries, and the EU has done little for EU neighbourhood countries. Meanwhile, euro-area membership has shielded from the crisis some countries with worse fundamentals than certain CEE countries.

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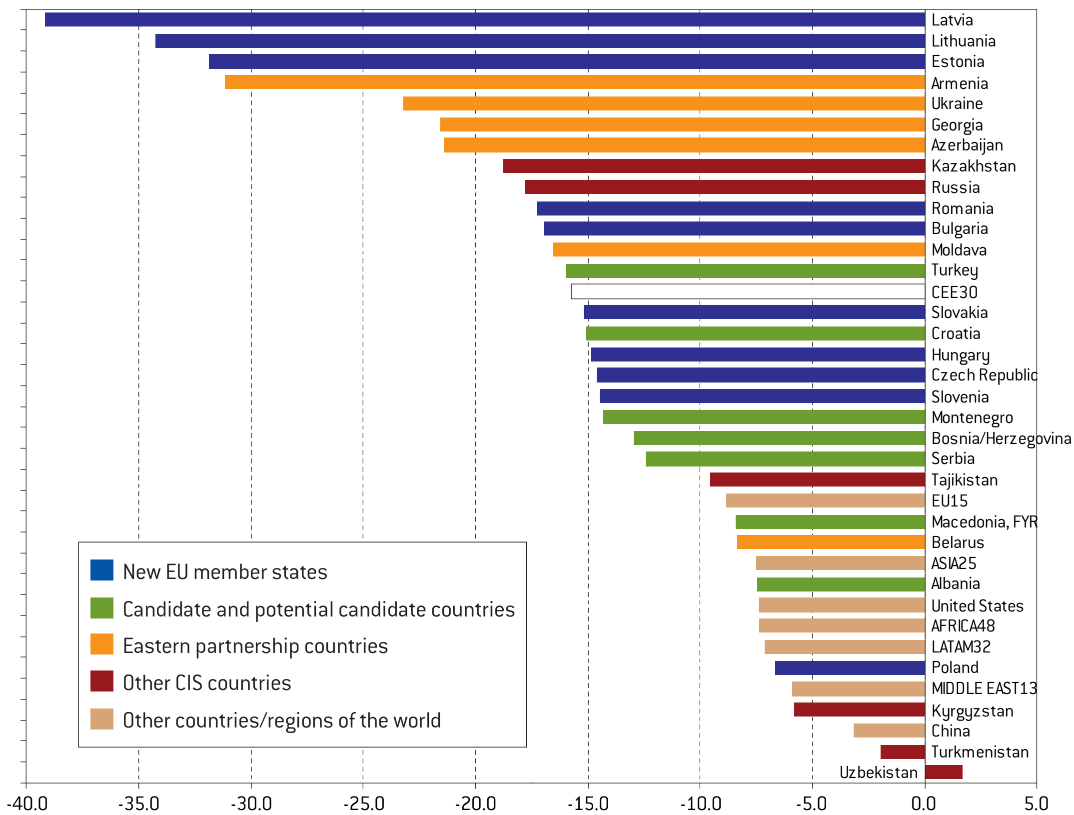
ZSOLT DARVAS, DECEMBER 2009

1. INTRODUCTION

Countries from central and eastern Europe (CEE) have been hit the hardest by the crisis, compared to other regions of the world. Figure 1 shows that in October 2009, the weighted average 2010 GDP level of 30 CEE countries was forecast to be 15.8 percent lower than was expected in October 2007[1]. There has been less downward revision in other emerging and developing country groups, ranging from 5.9 percent (average of 13 countries in the Middle East) to 7.5 percent (average of 25 Asian countries, excluding China and transition economies in Central Asia). The main epicentre of the crisis, the US, has suffered a 7.4 percent downward revision, while downward revision was 8.8 percent for the EU15. Figure 1 also indicates that there is great heterogeneity among CEE countries, and only a few of them have fared better than the EU15 average.

Figure 1: Downward revision of GDP level forecasts for 2010, October 2009 forecast compared to October 2007 forecast, percentage difference



Source: Author's calculations based on IMF and DG ECFIN forecasts published in October 2007 and October 2009.
Note. Values shown correspond to percentage difference between the 2010 GDP level forecasts made in October 2009 and in October 2007. Country group values are weighted averages (using GDP weights): CEE30: 30 countries from central and eastern Europe; EU15: the 15 members of the EU before 2004; ASIA25: 25 countries from Asia excluding China and transition economies in Central Asia; LATAM32: 32 countries from Latin America; MIDDLE EAST13: 13 countries from the Middle East; AFRICA48: 48 countries from Africa.

1. In our view, comparison to a benchmark, ie the downward revision of the forecast level of GDP at a future date, is a better measure of the severity of the crisis than the actual fall in GDP. However, the actual fall of GDP was also greatest in the CEE group of countries, compared to other regions of the world.

'EU integration benefited both CEE countries and western Europe, but contributed to huge credit, housing and consumption booms, high current-account deficits and external debt.'

Before the crisis, CEE countries seemed to be catching-up quickly and smoothly. The successful transition and pre-crisis catch-up process stood on four pillars:

1 Political and institutional integration into the EU, with ten CEE countries becoming EU members between 2004 and 2007, and higher hopes for many others for future membership;
2 Financial integration into the EU, which has led to, for example, significant foreign direct investment and lending to CEE countries, and also to the dominant position of western European banking groups in the banking system of most countries in the region;
3 Trade integration into the EU, as the EU became the dominant trading partner for most CEE countries;
4 Migration flows into the EU, as some countries in the region have experienced very large outflows of workers to western European countries, helping them to acquire new skills and achieve better living standards.

EU integration was not just beneficial to CEE countries but also to western Europe, as demonstrated by, for example, the assessment of the 2004/07 enlargement round by the European Commission (2009). EU integration, on the other hand, also contributed to the build-up of various vulnerabilities, such as huge credit, housing and consumption booms, and consequently high current-account deficits and external debt in many countries of the region. Pre-crisis complacency about the vulnerable structures was fuelled by the belief that decoupling saving and investment decisions was mostly the reflection of better utilisation of resources, with EU integration serving as a shelter against shocks.

The crisis that so severely hit CEE countries has led the EU and international financial institutions to take various actions to support the region. European institutions have several facilities that can be used to support crisis-hit countries. The crisis itself led to upgrades of some of the facilities and the introduction of some new ones. Furthermore, the procedures of some general facilities not related to the crisis were modified, enabling their use to help crisis-hit countries.

The purpose of this policy contribution is to take stock of the main instruments and channels by which the EU and western European economies have supported crisis-hit CEE countries. The aim is not to summarise all financial and other instruments directed towards new EU member states and other countries in the eastern neighbourhood, but only to list actions implemented in response to the crisis. To this end, we first summarise factors that mitigated the effect of the crisis, then discuss some amplifying factors, and close this contribution with some thoughts on assessment.

2. MITIGATING FACTORS

The EU medium-term financial assistance facility for non-euro-area EU countries. Since 1969 the EU has had a facility for granting loans to EU member states facing difficulties with their balance of payments[2]. The facility was redesigned in 2002 and the lending ceiling was set at €12 billion. In response to the crisis, the ceiling was raised to €25 billion on 25 November 2008 and to €50 billion on 5 May 2009. As part of a coordinated international lending programme, Hungary, Latvia and Romania have received loans from this facility, conditional on the implementation of comprehensive economic programmes aimed at ensuring fiscal consolidation, structural reform and support for the financial system. Table 1 details the sums provided by the lenders. The loans are disbursed in separate instalments according to the agreed schedule and progress of the implementation of the conditions. Lenders aims to coordinate but do not necessarily disburse the tranches at the same time[3]. The EU's contribution to these programmes is fully

2. For example, the last use of this facility for an EU15 country was a loan of ECU 8 billion to Italy approved by the Council on 18 January 1993. The loan was made available in four tranches of ECU 2 billion for an average period of six years.

3. For example, regarding the decision about the release of the second installment of the loan to Latvia, there was approximately a one month discrepancy between the decisions of the EU and the IMF in the summer of 2009 and this period was characterised by heightened uncertainty about what would happen in case the IMF declined to continue funding Latvia.

financed by bond issuance by the European Union. The EU loans under this facility (ie not considering individual EU member countries and European institutions) amounted from about 39 percent (Romania) to 182 percent (Latvia) of approved IMF loans.

Frontloading of structural and cohesion funds for EU member states. Although the allocation of structural and cohesion funds with the goals of supporting the EU's poorer regions and supporting infrastructure improvements within them is not related to the crisis, frontloading of disbursement was decided on in response to the crisis. Frontloading amounts to €11 billion of which €7 billion is for the new EU member states (see Barroso, 2009).

Expansion of the European Investment Bank's activities. The EIB, created by the Treaty of Rome in 1958 as the EU's long-term lending bank, raises funds on the capital markets with the aim of financing projects that further the EU's policy objectives. In response to the crisis, a decision was taken to significantly expand the Bank's activities, with an extra €15 billion per annum available in 2009 and 2010 – a 30 percent increase above average lending. Lending has advanced particularly strongly in three key areas: small and medium-sized enterprises (SMEs); energy and climate change mitigation; and investment in the poorer, 'convergence' regions of the EU. Convergence lending will increase by €2.5 billion per annum, with particular emphasis on the new EU member states. Most of the activities of the EIB are concentrated in EU countries, but the EIB also finances projects in the EU's neighbourhood.

Expansion of the European Bank for Reconstruction and Development's activities. The EBRD, which is not an EU institution but is owned by 61 countries, the European Community and the EIB, has also responded forcefully to the crisis. The EBRD facilitates project lending in 30 countries from central Europe to central Asia by borrowing funds on the capital markets. The EBRD has increased planned investments during 2009 to €7 billion from €5.1 billion in 2008, and concentrates on recapitalising sound banks, expanding the trade facilitation programme, financing energy and infrastructure projects, and setting up a corporate support facility.

The EBRD, EIB Group and World Bank Group joint action plan for bank lending. On 27 February 2009 the EBRD, EIB Group and World Bank Group announced a joint action plan to support with up to €24.5 billion in two years, CEE banking sectors and bank lending to businesses, in particular to small and medium-sized companies. Although

Table 1: Multilateral financial assistance including EU's balance of payment support for EU member states (€ billion unless otherwise noted)

Provider of the loan	Recipient of the loan: Hungary, Oct-Nov 2008	Latvia, Dec 2008 - Jan 2009	Romania, April-May 2009	Total for these three countries
EU	6.5	3.1	5.0	14.6
IMF	12.5	1.7	13.0	27.2
World Bank	1.0	0.4	1.0	2.4
Sweden, Denmark, Finland, Estonia and Norway		1.9		1.9
EBRD, Czech Rep and Poland		0.4		0.4
EBRD and EIB			1.0	1.0
Total	**20.0**	**7.5**	**20.0**	**47.5**
Total (% of 2008 GDP)	19%	32%	15%	18%
EU loans (% of IMF loans)	52.0%	182.4%	38.6%	53.8%

Source: European Commission.

'A large proportion of the banks in CEE countries is owned by western European banks. Without this western ownership, banks in the region would probably have been denied euro liquidity altogether.'

this initiative is part of the EIB and EBRD activities discussed above, it has a crucial role and it is hence important to emphasise it separately, not least because of its coordinated nature and the participation of the World Bank. The financial support will include equity and debt finance, credit lines and political risk insurance.

Foreign ownership of CEE banks. A large proportion of the banks in CEE countries is owned by western European banks. Without western ownership, banks in the region would probably have been denied euro liquidity altogether. The commitment not to let any systemically-important bank fail in the euro area and also in Sweden (whose banks own most of the banking system in the Baltic countries), the EU political commitment that packages helping international banking groups can benefit subsidiaries, and the ECB's liquidity support to euro-area banking groups, also helped their subsidiaries in the CEE region[4].

The 'Vienna Initiative'. This is a multilateral effort to secure financial sector stability in those CEE countries with substantial foreign bank ownership. It stipulates coordination between all relevant stake holders, including international banking groups, home- and host-country authorities, international financial institutions and the EU, with the aim of developing a common understanding. It aims to secure the commitments by both international banking groups and home and host-country authorities, and to coordinate a fair burden sharing (see Box 1.4 in EBRD 2009).

Agreements between European central banks. Table 2 summarises the main liquidity provision agreements between European central banks. Three CEE countries (Estonia, Latvia and Lithuania) are participating in the EU exchange rate

Table 2: Liquidity provision agreements between European central banks (date of introduction in brackets)

	ECB	Denmark	Sweden	Norway	Switzerland
Denmark	Swap (27/10/08) ERM-II facility (1/1/99)				
Sweden	Swap *Date not announced*				
Switzerland	Swap (1/10/08)				
Hungary	Euro repo (10/10/08)				Euro/CHF swap (28/1/09)
Poland	Euro repo (6/11/08)				Euro/CHF swap (17/11/08)
Estonia	ERM-II facility (28/6/04)		SEK/EEK swap (27/2/09)		
Latvia	ERM-II facility (2/5/05)	Euro/lats swap (16/12/08)	Euro/lats swap (16/12/08)		
Lithuanuia	ERM-II facility (28/6/04)				
Iceland		Euro/ISK swap (16/5/08)	Euro/ISK swap (16/5/08)	Euro/ISK swap (16/5/08)	

Source: Central bank websites. Note. The swap agreement between the ECB and the Sveriges Riksbank was announced retrospectively in the Annual Report of the Riksbank without indicating the date of introduction. Major European central banks (ECB and the central banks of Denmark, Norway, Sweden, Switzerland and the United Kingdom) have swap agreements with the Federal Reserve.

4. Statistical analysis presented in EBRD (2009) suggests that foreign bank presence attenuated the capital outflow after the collapse of the Lehman Brothers in September 2008.

mechanism (ERM-II). Since these countries unilaterally maintain no or very narrow exchange rate bands, the short-term financing facility available for ERM-II participants to support the stability of the exchange rate has not yet been used, because this facility is to be used primarily at the boundaries of the official +/-15 percent wide band[5].

The central banks of Denmark and Sweden offered Latvia currency swaps between euro and Latvian lats (ie temporary exchange of the two currencies). Sweden also offered to Estonia a Swedish krona/Estonian kroon swap. The option of getting foreign exchange liquidity in exchange for domestic currency alleviates the pressure on domestic currency markets.

The European Central Bank offered euro repurchase agreements (repo) to Hungary and Poland. Under these agreements the two CEE central banks can receive temporary euro liquidity in exchange for securities eligible for ECB transactions, such as euro-denominated government bonds issued in the euro area. This repo does not involve a change in currency denomination. Still, it was useful, because the Hungarian and Polish central banks could support their domestic banks with euro liquidity without giving the impression of falling foreign exchange reserves, as a repo does not affect the headline number for foreign exchange reserves[6].

The Swiss National Bank offered euro/Swiss franc swaps to Hungary and Poland thereby helping these countries to get Swiss franc liquidity in exchange for euros. Since Swiss franc lending became widespread in these countries, but money market conditions in western Europe made it rather difficult to get Swiss franc liquidity, this facility was also helpful.

Boosting IMF resources by €125 billion. In response to the April 2009 G20 meeting, European governments have committed to provide €125 billion to the IMF, which is 35 percent of the increase in the IMF's lending capacity from $250 billion to $750 billion. Since the CEE region is the largest recipient of IMF loans, part of this contribution will arrive in the region (see eg the European Commission's press release IP/09/1656).

Macro-Financial Assistance (MFA) to third countries. This is a policy-based financial instrument of untied and undesignated balance-of-payments support to partner third countries. It takes the form of medium/long-term loans or grants, or a combination of these, and in many cases it has complemented financial support from other international financial institutions. MFA loans are financed through EU borrowings on the market. MFA grants are financed under the EU's budget. The annual disbursement under this facility declined to a range of €20-€67 million between 2004 and 2007. At the time of writing, no comprehensive information is available on the use of this facility[7] and hence Table 3 showing the result of our data collection based on various Commission press releases may not be complete.

All MFA loans indicated in Table 3 were proposed by the Commission in October 2009, ie well after the conclusion of the talks for the IMF Stand-by Agreements, though certain other supports to some of these countries were implemented earlier (see below). The MFA loans proposed amounted from about four percent (Ukraine) to 11 percent (Armenia) of previously-approved IMF loans.

Instrument for Pre-accession Assistance (IPA). To express the EU's solidarity during the global economic crisis with the pre-accession countries, in February 2009 the Commission proposed to extend its Economic Recovery Plan for the Western Balkans. To this end, at least €120 million IPA funds was planned to be allocated to support the economic and social consolidation of the region

'The European Central Bank offered euro repurchase agreements to Hungary and Poland. This was useful, because the Hungarian and Polish central banks could support their domestic banks with euro liquidity without giving the impression of falling foreign exchange reserves.'

5. Slovakia was also an ERM II member before joining the euro area, and it relied on the full flexibility of the +/- 15% wide band. After strong appreciation pressures, the central parity of the Slovak koruna was revalued twice (see Figure 13 in Darvas, 2009b). The second revaluation, which set the new central rate to the previous lower limit of the ERM II band (SKK/EUR 30.126), took place with effect from 29 May 2008. The ECOFIN Council decided on the same final conversion rate on 8 July 2008. Between late May 2008 and the end of 2008 the Slovak koruna remained very close to this conversion value, although some depreciation was observed in October 2008 to about a rate of 30.8. However, no central bank interventions were conducted in the foreign exchange market because Slovakia's credible euro-area entry prospect induced a sufficient motive for banks to enter arbitrage deals (see Section 3.2 in Národná Banka Slovenska, 2009).

6. The Danish and the Swedish central banks (which had swap agreements with both the ECB and the central bank of Latvia) had, at least in principle, the possibility of channeling euros from the ECB to Latvia in exchange for lats.

7. As of 23 December 2009, the latest information available at the Commission's website dedicated to this facility refers to the year 2007: http://ec.europa.eu/economy_finance/financial_operations/market/third_countries/index_en.htm

Table 3: EU's macro-financial assistance (MFA) and earlier IMF Stand-by Agreements for the countries concerned

	MFA loans: Amount and date of Commission's proposal to the Council	MFA grants: Amount and date of Commission's proposal to the Council	IMF Stand-by Agreement (loans): amount and date of Staff Level Agreement	Total loans from IMF and EU (% of 2008 GDP)	EU loans (% of IMF loans)
Armenia	€65 million 16 October 2009	€35 million 16 October 2009	€ 414 million, 3 March 2009; increased to €587 million on 22 June 2009	8.0%	11.1%
Bosnia and Herzegovina	€100 million 30 October 2009		€1.12 billion 5 May 2009	9.6%	9.0%
Georgia		€46 million* 16 October 2009	----		
Serbia	€200 million 8 October 2009		€407 million, 17 November 2008; increased to €2.94 bn on 15 May 2009	9.2%	6.8%
Ukraine	€500 million 29 October 2009		€12.33 billion 26 October 2008	10.5%	4.1%

Sources: Commission press releases IP/09/1535, IP/09/1475, IP/09/1654, IP/09/1659. IMF press release 08/259, 08/289, 09/52, 09/151, 09/169, 09/228. Note. IMF loans were converted into euros using the exchange rate of the month of staff level agreement. * The MFA grant of €46 million to Georgia is part of a comprehensive EU package up to €500 million to support Georgia's economic recovery, pledged at the October 2008 Donor Conference in the aftermath of the August 2008 conflict with Russia.

(Commission press release IP/09/204). On 31 July 2009, the EU approved a €100 million grant to Serbia from the IPA budget (Commission press release IP/09/1213) and, on 11 August 2009, a €39 million grant to Bosnia and Herzegovina (Commission press release IP/09/1230).

Crisis Response Package for the south eastern Europe. Commission grants amounting to €150 million have been allocated to support economic stability and development in south-eastern Europe. On 31 July 2009 the EU approved an €85 million financial crisis package for the western Balkans and Turkey from this facility. This grant is augmented with loans from the EIB and EBRD (Commission press release IP/09/1213).

Supporting western European economies. Since most CEE economies are generally small and open and have achieved a high degree of trade and financial integration with western European economies, all measures aimed at supporting western European economies had an indirect positive impact on CEE countries.

EU membership. Finally, for EU members, the fact of membership is certainly a stabilising factor. It has helped to strengthen policy institutions in the new member states, has enhanced their credibility, has improved the business climate, and symbolises the irreversible character of integration between the previously separated parts of Europe. EU membership can also be regarded as an 'insurance policy' as countries can rely, if needed, on the EU facilities discussed so far. In candidate and potential candidate countries the prospect of EU membership and the work done to fulfil membership conditions also helped to strengthen institutions and to improve the business climate before the crisis, leading to, among others, capital flows in the form of FDI. Better institutions and large stocks of FDI (especially in the banking industry as argued before) likely cushioned the impact of the crisis.

3. AMPLIFYING FACTORS

Certain actions, or failures to act, on the part of EU institutions and governments, have amplified the effects of the crisis on CEE countries.

Uncoordinated sequence of deposit guarantee

upgrades. Starting in September 2008 euro-area governments substantially increased their deposit guarantees (some are unlimited), but at first in a uncoordinated fashion. Subsequently, joint decisions were made and new member state governments also introduced such measures[8]. But the uncoordinated sequence of deposit guarantee upgrades may have compounded the lowering of the credibility of CEE governments and the capital flight to 'quality' that has characterised the crisis (see Darvas and Pisani-Ferry, 2009).

Asymmetric liquidity and credit management. While western European parent banks did provide continued access to liquidity for subsidiaries, and we have argued that their presence had a stabilising role in the CEE region, anecdotal evidence also suggests that in periods of heightened stress some of them have prioritised hoarding of liquidity at home. Banks may also curtail credit asymmetrically in the future. This could either be a rational response to deteriorating economic conditions in the CEE countries, or a result of the banks' objective to decrease their exposure to CEE due to the necessary deleveraging.

Restricted access to euro liquidity. The near-paralysis of the euro-area interbank money market implied that (especially non-foreign-bank owned) commercial banks in the CEE countries were largely cut off from euro liquidity. The more the ECB was (rightly) moving into new territory to remedy the shortage of liquidity in the euro area, the more it was inadvertently putting CEE banks – at least those without access to a parent bank's liquidity – at a disadvantage. Domestic central banks could have provided euro liquidity by drawing on their foreign currency reserves, but in times of crisis, this is not deemed sensible. As shown in Table 2, the ECB did not provide currency swaps to any of the new EU member states, though it provided swaps to Denmark and Sweden. In this sense, the ECB did not follow the Federal Reserve, which provided currency swaps to not just all industrialised countries, but also to Brazil, Korea, Mexico and Singapore. As well as direct help, swaps at least to new EU member states would have improved market sentiment, thereby decreasing the pressure on the financial markets in these countries.

Securities eligible for ECB refinancing. The list of securities eligible for ECB refinancing was expanded substantially to include lower-quality securities and non-euro denominated securities[9], in response to the crisis, but was not expanded to include local-currency denominated bonds issued by the governments of the non euro-area countries. While this was a perfectly natural provision when the European money markets worked smoothly, the liquidity shortage made it unattractive for euro-area financial institutions to hold non-euro government bonds, thus contributing to their sell-off.

ECB operations with non-euro area commercial banks. The suggestion that temporary access to ECB facilities should be given to non-euro area commercial banks, which could have substituted the malfunctioning euro-area money market for these banks, was not implemented. This non-implementation has disadvantaged CEE banks that relied heavily on euro-area money markets before the crisis, especially those banks that did not have a western European parent bank.

A 'mega-fund' for CEE. Some academics, but also the prime minister of Hungary, advocated the setting up of a fund of several hundred billion euros for various purposes, such as replacing the shortfall in private capital flows to the region and supporting local banks. To the extent that such a fund could have alleviated the undue pain felt by some CEE countries, the lack of its establishment disadvantaged these countries.

Euro area enlargement. The European Commission, the ECB and major euro-area member states did not change their position regarding euro-area entry. Euro-area entry criteria were set up in the early 1990s when the euro area did not exist and the EU had 12 members. The economic foundations of the criteria are fundamentally flawed, as euro-area members continue to violate the criteria, while the EU's expansion to 27 members has made the criteria tougher for new member states

8. Ireland was the first euro-area country to offer unlimited bank deposit guarantee after the nationalisation of Northern Rock by the UK government, which offered unlimited deposit guarantees also in Ireland. Ireland was first accused of giving unfair advantage to its banking system by other western European governments. A few days later, however, other euro-area governments increased substantially their guarantees (in some cases, e.g. Germany and Austria, also to an unlimited amount). On 7 October 2008, EU finance ministers agreed to raise the level of deposit guarantees to a minimum of €50,000 in all EU member states.

9. On 15 October 2008, the ECB decided to expand the list of assets eligible as collateral in Eurosystem credit operations by non-euro denominated instruments, namely in US dollars, British pounds and Japanese yen, provided the security was issued in the euro area.

to meet. European officials did not initiate the adaptation of the entry criteria to the new circumstances, though the European Council has the ability to reform the criteria without a formal treaty change (Darvas, 2009b). This resistance to change disadvantaged countries that were seeking the stability and credibility offered by euro-area membership.

4. ASSESSMENT

The crisis has hit central and eastern European countries harder than other regions of the world. To express solidarity, but also to recognise the EU's responsibility toward a region that is highly integrated in political and economic terms into the EU, the EU and EU-related institutions have mobilised substantial funds (predominantly in the form of loans) to support crisis-hit countries in the region. In addition, other indirect channels were employed by the EU to help CEE countries cope with the crisis. Yet there were certain actions, or failures to act, on the part of EU institutions and governments, that have amplified the effects on CEE countries of the crisis.

As emphasised by, eg IMF (2009), EBRD (2009) and Mitra *et al* (2009), though there have been dramatic declines in the national outputs of CEE countries, the 'worst problems from past crises', such as currency overshooting, bank runs and collapses of banking systems, have so far been avoided. The EU has certainly played an important role in this, but it is difficult to assess the direct impact of the various facilities and channels because there are many factors at play at the same time. For example, market sentiment towards CEE countries, and hence capital flows, depends not just on EU-related policies, but on, among other factors, the perception of domestic policy measures adopted in the CEE countries, actions by international financial institutions and global market sentiment. Still, there are certain developments that are worth summarising regarding the role of the EU in supporting crisis-hit CEE countries.

First, multilateral financial assistance in the form of coordinated loans had stabilising effects. Both the announcements of new agreements and the subsequent confirmation of the disbursement of additional tranches calmed markets, and have led to currency appreciations and interest-rate falls.

Second, the banking system played a crucial role. The financial sectors were relatively sound (compared with the Asian countries in the 1990s, see eg EBRD, 2009) before the crisis and western European banks – which own the majority of banking systems in CEE countries – have remained committed to the region. Available information suggests that western European parent banks have mostly rolled over expiring liabilities of subsidiaries and have also remained committed to recapitalising subsidiaries if needed. Domestic credit aggregates are contracting in many CEE countries, but it is not possible to determine the roles of supply and demand conditions in this development. Efforts to coordinate parent bank behaviour, as well as ECB support for parent banks, and the EU's political commitment to the support of subsidiaries, have certainly played important roles.

Third, the little direct support given by the ECB to countries outside the euro area (apart from swap lines to Denmark and Sweden) is difficult to rationalise for an outside observer. The suggested swap, collateral and banking cooperation arrangements – when accompanied by proper risk management practices – would have not posed a risk of losses for the ECB beyond the risk inherent in standard ECB operations, but would have been a natural (temporary) response to the implications of the drying-up of liquidity in euro-area money and swap markets to the CEE financial systems. Such ECB responses would have alleviated the stress on CEE money, government bond and currency markets.

Fourth, the non-establishment of a 'mega-fund' to support CEE economies is controversial. One could probably design a fund that could well augment available facilities without creating moral hazard, but the lack of clarity in the various proposals, the existing facilities and the standard (non-crisis) EU supports to new member states and other neighbourhood and developing countries, made EU and western European policymakers understandably reluctant.

Fifth, a comparison of countries inside and outside the euro area suggests that euro-area membership is a great shielding factor in times of crisis. In the current crisis, some euro-area members with worse fundamentals fared much better then some CEE countries outside the euro area with better fundamentals (see, eg the brief comparison between Greece and Hungary in Box 1). The reluctance to reform the euro-area entry criteria, despite their well-known deficiencies and the questionable precedents of some of their previous applications (Darvas, 2009b), have not made crisis management easier in the new EU member states.

Finally, the EU has mobilised substantial funds to support new EU member states directly, but crisis support for the neighbourhood countries was largely left indirectly for the international financial institutions and western European banks with subsidiaries in those countries. As Darvas (2009a) argued, the respectable European boost to the resources of the IMF does not do away with the need for substantial direct EU involvement in crisis support beyond its borders. Direct support from the EU would also have a strong signalling effect, and the EU's stand during the crisis could have had far-reaching consequences for the relationship between the EU and its partner countries. The Commission's October 2009 proposals to extend loans to neighbourhood countries were undoubtedly important and helpful, but somewhat late, and one may also argue that the proposed volume of lending is relatively small.

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BOX 1: THE EURO SHELTER: HUNGARY VERSUS GREECE

The cases of Hungary and Greece strongly underline that euro-area membership makes a difference when it comes to crisis response. Both countries are EU members but only Greece is in the euro area. Both countries had fiscal problems before the crisis in the form of large budget deficits and high or rising government debt, but Greece has fared much better than Hungary in the crisis despite worse fundamentals.

For example, Greece had much higher government debt (Figure 2), a more-or-less similar budget deficit (Figure 3) and a much higher current-account deficit (Figure 4) than Hungary before the crisis (all expressed as a percentage of GDP). Despite the differences in these fundamental vulnerability indicators, Hungary experienced serious speculative attacks on its currency and government bond markets, and had to rely on a multilateral financial-assistance programme, while tensions in Greece were milder. Hungary's current-account deficit is expected to shrink from 6.5 percent of GDP in 2007 to below two percent of GDP in 2009-2011, while Greece is still expected to have a current account deficit around eight percent of GDP in the coming years, according to DG ECFIN's October 2009 forecasts. The government debt-to-GDP ratio is expected to expand in Greece to 135 percent by 2011, in contrast to Hungary, where it is expected to stabilise somewhat below 80 percent. While the spread over German 10-year government bond has increased to some extent in Greece in response to the crisis, in Hungary, where the spread was already high before the crisis, the hike induced by the crisis was much larger than in Greece (Figure 5). Even in December 2009 when concerns about the sustainability of Greek public finances intensified and the chance of eventual IMF intervention in Greece – notwithstanding the emphatic denials – has increased, the resulting interest-rate increase was small compared to interest-rate rises in Hungary during the crisis.

Figure 2: General government gross debt (% GDP), 1990-2011

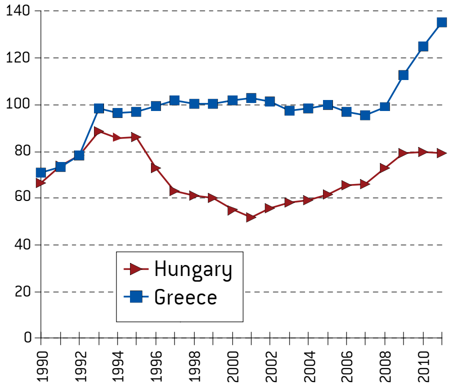


Figure 3: General government balance (% GDP), 1990-2011

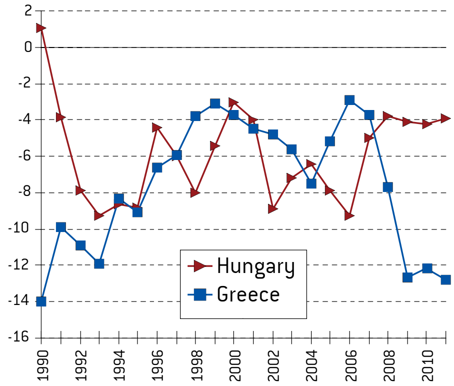


Figure 4: Current account balance (% GDP), 1990-2011

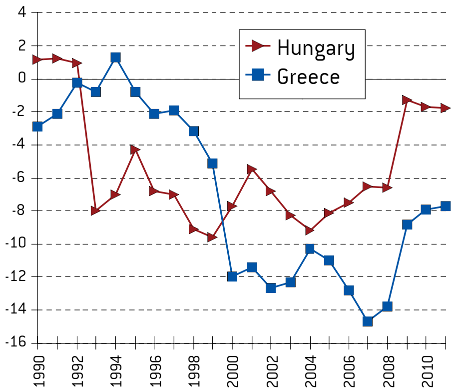
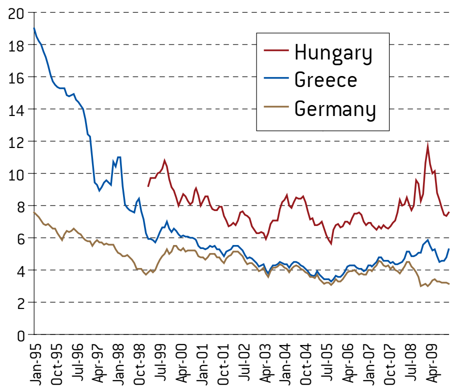


Figure 5: 10-year government bond yields (%), Jan 1995-Dec 2009



Sources: Eurostat, ECB, IMF, Datastream and October 2009 forecast of DG ECFIN. Note. Government bond yields for December 2009 were calculated as the averages of daily data between 1 and 21 December 2009.